

Philippine Economic *Outlook*

MARCH 2002

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EMBASSY OF THE UNITED STATES OF AMERICA

1201 Roxas Boulevard, Manila, Philippines
Tel: (63)(2) 523-1001; Fax: (63)(2) 522-4361

FRANCIS J. RICCIARDONE
Ambassador

ROBERT W. FITTS
Deputy Chief of Mission

MORTON J. HOLBROOK
Economic Section

GEORGE F. RUFFNER
Foreign Commercial Service

CHARLES ALEXANDER
Foreign Agricultural Service

PATRICIA K. BUCKLES
USAID

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Introduction

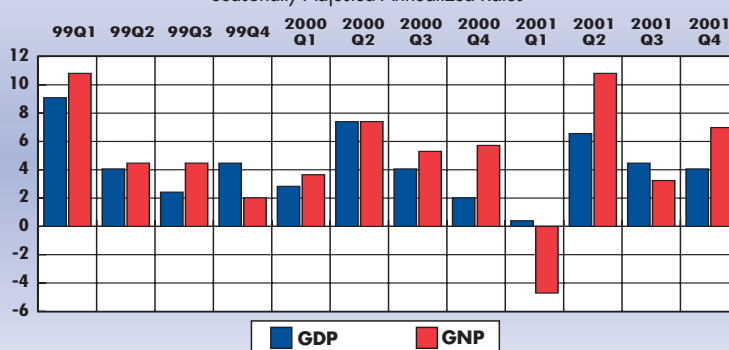



This edition of the *Philippine Economic Outlook* coincides with the completion of President Gloria Macapagal-Arroyo's first year in office, a year filled with rapid political change and challenges at home and a deteriorating international business environment. Within that context, the Philippine economy fared better than most observers expected during the fourth quarter of 2001 and for the year as a whole despite the electronic sector meltdown and global economic slowdown, and the added global uncertainties posed by the September 11 terrorist attacks on the United States and domestic security concerns.

The country's economic growth (second best in the region after China), its enhanced macroeconomic condition, and greater budgetary discipline bolstered President Macapagal-Arroyo's political support and improved business confidence, pushing the stock market to new highs. Economic output benefited from the agricultural sector's stronger performance, combining with the relatively resilient service sector to compensate for the industrial sector's continued weakness. At the same time, however, the rate of population increase reduced real per capita growth to barely 1% — far less than the expansion needed to put the Philippines on the path to sustained economic development and poverty reduction.

The fourth-quarter Gross Domestic Product (GDP) expansion pushed up the full year 2001 growth rate to 3.4% — achieving the government's downward-revised 3.3% goal. As expected, the 2001 GDP expansion slowed vis-a-vis 2000's performance but, nevertheless, beat late-year consensus forecasts. The government's targeted GDP growth range for 2002 is 4.0%-4.5%. Our own forecast is for real GDP growth in the 3.5%-4.0% range. Prospects for Philippine exports and investments have improved on expectations of a second-semester U.S.-led global recovery and generally more affordable domestic financing costs. However, these demand factors may not bounce back as quickly as the government hopes because of under-utilized capacity, obstacles to more aggressive bank lending posed by rising levels of non-performing assets, the lingering inertia in

QTR.-to-QTR. GDP & GNP GROWTH
Seasonally Adjusted Annualized Rates





private construction activity and, especially for foreign investors, lingering domestic security and peace-and-order concerns.

Saddled with non-performing loans and a growing portfolio of foreclosed assets, banks remained cautious lenders, while weaker economic prospects translated to conservative credit demand. Overall, the Philippine banking system's generally healthy capital-adequacy ratios as well as adjustments in loan-loss reserves have helped the banking system avoid systemic problems. A number of banks are actively exploring setting up or using the services of asset management companies to clean up their non-performing accounts, some with U.S. firms such as Lehman Brothers and Cerberus. As part of its priority legislative agenda, the government is pushing for the passage of legislation which seeks to promote asset securitization and the creation of asset management companies to help banks clean up their portfolio of non-performing assets.

In the equities market, stock prices began inching up due to more aggressive interest-rate reductions, reported victories by U.S.-led counter-terrorism efforts, positive inflation numbers, and the peso's relative stability. The Philippine Stock Price Index (Phisix) nevertheless closed 2001 at 1,168.08, down 21.8% from end-2000. Twenty-nine PSE member-broker firms ceased or suspended operations during 2001 (including 17 foreign brokerages). However, the Phisix closed at 1,416.83 on February 15, the highest in 7-1/2 months, buoyed by foreign investors positioning themselves for potential upsides in under-weighted and under-performing Philippine stocks. According to stock market traders, the arrival of U.S. troops engaged in the government's anti-terrorism drive against the Abu Sayyaf group also helped boost investor sentiment.

The government was able to project an image of fiscal responsibility by containing the 2001 budget deficit close to the targeted ceiling. Revenues exceeded the government's revised target by P5.5 billion mainly because of the Treasury's much higher-than expected income — which offset an P8.9 billion shortfall in customs collections and in privatization receipts. The Bureau of Internal Revenue slightly exceeded its reduced 2001 collection goal, resulting in an actual 2001 fiscal deficit of P147 billion. President Macapagal-Arroyo signed the national government's P780.8 billion (US\$15.3 billion) budget for 2002 into law on January 21 — after functioning under a re-enacted 2000 budget for the 2001 calendar year. Although 11.6% higher than 2001, the 2002 budget nevertheless remains tight, with over 75% of the budget pie going to non-discretionary expenditures such as personnel costs and debt service. The leeway available for remaining budget items will, therefore, depend heavily on the government's ability to meet revenue goals. Geared towards reining in the national government's 2002 fiscal deficit within a lower P130 billion (3.3% of GDP) ceiling, the 2002 revenue program calls for a 17% year-on-year expansion in tax collections. All told, the government continues to juggle extremely inadequate resources even as demands intensify for the current administration to deliver on its anti-poverty promises.

To support low domestic interest rates, the government's goal is to shift the financing burden to foreign borrowings in 2002 to the tune of about \$2.8 billion. About \$1.3 billion of that amount will depend on the government's ability to improve utilization of concessional official development assistance (ODA) loans, an issue of long-standing concern to foreign donors. The remaining \$1.5 billion of the national government's 2002 foreign borrowing program consists of commercial credits. The foreign debt service burden spiked to 15.1% during the first ten months of 2001. If the ratio holds at about 15%-16% for the full year (as the BSP estimates), this will be the highest foreign debt service burden posted since the mid-1990s. These developments suggest vulnerabilities to unexpected reversals in export markets.

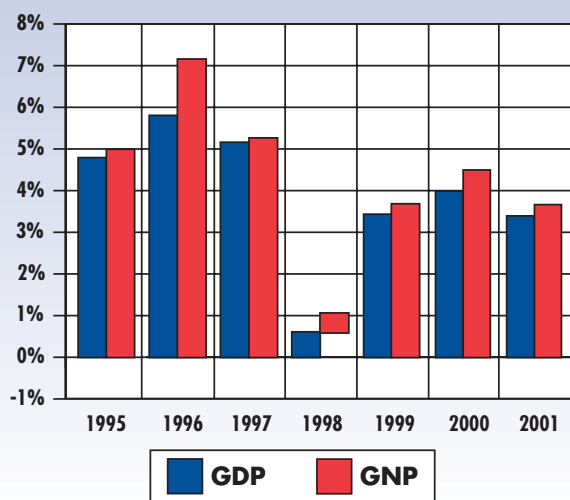
The peso has strengthened, buoyed in part by heftier December 2001 and January 2002 gross international reserve levels and a number of encouraging domestic news items (including positive reports on the inflation and fiscal fronts and Moody's sovereign-rating upgrade). Budgetary control, if sustained, and more moderate inflation will be plus factors for a relatively stable peso. Provided there are no severe external and/or domestic shocks, our current reading is for a modest peso depreciation to an average 2002 rate of P51.60-P52.25/US\$.

The Macapagal-Arroyo government has assembled a well-respected economic team, which deserves praise for its strong resolve to maintain fiscal discipline. Achieving long-term fiscal viability will require strong political will, especially where perceived corruption and inefficient tax collection have increased public resistance to new taxes and eroded the intended gains of past restructuring efforts. Beyond the immediate challenge of allocating scarce resources among competing needs, effective revenue mobilization remains crucial to sustaining a responsible deficit-reduction plan that supports the needs of a growing population, addresses serious infrastructure deficiencies, and harnesses the human-resource capabilities demanded by intensifying global competition.

Output and Inflation

The Philippine economy fared better than expected by many during the fourth quarter of 2001 despite the added global uncertainties posed by the September 11 terrorist attacks on the United States and escalating domestic security and peace-and-order concerns. Seasonally-adjusted figures show that Gross Domestic Product (GDP) managed to grow by 1.0% quarter-on-quarter, more or less sustaining its 1.1% third-quarter expansion. Economic output benefited from the agricultural sector's stronger performance, combining with the relatively resilient service sector to compensate for the industrial sector's continued weakness. Industrial-sector output — hardest-hit by the global economic slowdown and electronics-demand slump — retreated by 0.3% quarter-on-quarter.

REAL YEAR-TO-YEAR GDP & GNP GROWTH



According to the more widely-used gauge of overall economic activity — measured as the year-on-year change of seasonally-unadjusted data — real GDP grew by 3.8% during the fourth quarter of 2001. The fourth-quarter's year-on-year GDP expansion, unexpectedly the highest during 2001, surpassed independent economists' expectations of weaker growth during the last three months of the year.

On the production side, fourth-quarter domestic output received a boost from the robust 5.9% year-on-year expansion registered by the agricultural sector (which logged its strongest performance since 2000's fourth quarter). The service sector's overall output increased by 5.3%, also improving on its January-September 3.9% year-on-year increase. That resilience mainly reflected the continued strong expansion of communications-related services, the stronger growth rate posted by the trade sub-sector, and a fourth-quarter acceleration in government services. Although still weak, modest improvements posted by the finance and real estate sub-sectors also contributed. On the other hand, fourth-quarter industrial output sputtered to its lowest growth rate since the third quarter of 1999 — pulled down by manufacturing (up a mere 0.8%) and construction (down 2.7%).

Demand-wise, consumer spending (up 3.7% in real terms during the fourth quarter) held its own, helped by improved rural incomes (i.e., agriculture traditionally absorbs 40% of total Philippine employment) and relatively stable prices. Businessmen commented that heightened fears of a more pronounced economic slowdown in the aftermath of the September 11 terrorist attacks prompted many establishments to offer sales and discounts despite thinner margins in order to get stocks moving and spur Christmas-related spending. Overall fourth-quarter demand also received a push from a build-up in inventories, with stronger government consumption also contributing (following declines during 2001's second and third quarters). These demand factors made up for the deeper fourth-quarter decline in exports and a 4.1% contraction in fixed-capital investments.

The 3.9% fourth-quarter GDP expansion pushed up the 3.3% growth rate in the first nine months of 2001 to a full year rate of 3.4% — achieving the government's downward-revised 3.3% GDP growth goal. As expected, the 2001 GDP expansion slowed vis-a-vis 2000's 4.0% performance but, nevertheless, beat late-year consensus forecasts of 2.5%-3.0% growth for the full year. On a full year basis, only the agricultural sector (up 3.9%) surpassed its 2000 performance (3.3%). The service sector (which logged a 4.3% expansion) more or less approximated its 2000 growth rate (4.4%), propped up by somewhat stronger performances from trade and government services. On the demand side, exports (which reversed from 17.7% growth to a 3.2% decline in real peso terms) and lethargic fixed-capital investments (down 0.6%) dampened growth prospects. However, full year consumer spending (which increased 3.4%) more or less hung on to its 2000 growth pace (3.5%). Businesses also built up sagging inventories following three consecutive years of net draw-downs; and government consumption, although practically flat year-on-year, at least avoided a further decline from 2000's 1.1% contraction.

The government's targeted GDP growth range for 2002 is 4.0%-4.5%. Our own forecast is for real GDP growth in the 3.5%-4.0% range. Agriculture faces another (albeit milder) El Niño spell and may not be able to provide the same push to output and consumption seen last year. Meanwhile, government spending may be limited by determined deficit-reduction efforts unless revenues improve. These uncertainties place the greater burden on the private non-agricultural sector to build on 2001's growth performance. Prospects for Philippine exports and investments have improved on expectations of a second-semester U.S.-led global recovery and generally more affordable domestic financing costs. However, these demand factors may not bounce back as quickly as the government hopes because of under-utilized capacities, hindrances to more aggressive bank lending posed by rising levels of non-performing assets, the lingering inertia in private construction activity and, especially for foreign investors, lingering domestic security and peace-and-order concerns.

Year-on-year consumer price inflation averaged 6.1% during 2001, at the lower end of the government's 6.0%-7.0% targeted range. Although higher than 2000's 4.4% average, inflation (which opened that year at 6.9%) began to slow successively starting August 2001 and, by December, had slowed to a year-on-year rate of 4.1% — the lowest in nearly 1-1/2 years. By January 2002, year-on-year inflation had slowed further to a 21-month low of 3.8%. The decelerating trend, which gained momentum towards the fourth quarter of 2001, reflected a stabilizing exchange rate, softening world oil prices (which allowed a number of domestic-price rollbacks), and good agricultural output. Prices also came off a relatively high second-semester 2000 base (during which cost-push adjustments from foreign exchange and oil price pressures had accelerated). The government's goal is to contain average year-on-year inflation to between 5.0%-6.0% in 2002, which we consider achievable and will be supported, starting this year, by the adoption of inflation targeting as the framework of Philippine monetary policy.

Labor and Employment

As of October 2001, the total labor force was 33.4 million, up 7.9% from the previous year. Of these, 3.27 million were unemployed and 5 million were underemployed. The labor force participation rate was 67.5%. The full year unemployment rate for 2001 (which the government computes as the average of its January, April, July, and October surveys) remained steady at 11.2%, but the labor force participation rate grew to 67.1%, the highest in recent years. The increase in the labor force participation rate was most pronounced among women and young workers. Employment in the agriculture, fishery and forestry sector rebounded, while industry and manufacturing also posted a turnaround from a slump last year. Employment in the service sector increased by 6.1% over the previous year.

While the employment expansion in 2001 appeared broad-based, it is worth noting that 87.7% of the year-on-year growth reflected an increase in part-time (versus full-time) workers. Furthermore, nearly 70% of the employment expansion represented increases in unpaid family workers and the self-employed — suggesting that labor force entrants may have moved to the informal sector because of limited opportunities in the formal economy.

Reflecting the global economic slump, the cumulative number of establishments filing notices of permanent layoffs and closures during the first 11 months of 2001 had reached 2,565, up from 2,060 during the same period the previous year. Despite a brief slowdown following the September 11, 2001 terrorist attacks in the United States, the Department of Labor and Employment reported that the deployment of overseas Filipino workers (OFWs) had stabilized. For displaced OFWs, the government's Overseas Workers Welfare Administration, together with the Catholic Bishops Conference of the Philippines Episcopal Commission on Migrants and Itinerant Workers, created a Joint Coordinating Council and a Quick Reaction Team to ensure that returning OFWs would be given necessary assistance.

OFWs remitted a total of US\$4.84 billion during the first 10 months of 2001, compared with US\$5.1 billion remitted for the

same period the previous year. To tap OFW funds for investment, the National Treasury reported that the government would issue US\$100 million in bonds, called *Bagong Bayani* (New Heroes) Bonds. To boost Philippine economic development for 2002, the Macapagal-Arroyo administration announced the allocation of P2.665 billion for skills training to help Filipino workers land better paying jobs, both domestically and abroad.

The National Conciliation and Mediation Board (NCMB) reported 43 strikes during 2001, down from 60 in 2000. There were nearly 207,000 workdays lost to strikes, compared with nearly 320,000 in 2000. The average duration of strikes in 2001 increased to 37 days from 26 days in 2000. Since Gloria Macapagal-Arroyo took office, NCMB has intensified its efforts to promote labor-management cooperation and voluntary arbitration. A number of threatened strikes against local operations of multinational corporations have been averted through the intervention of NCMB.

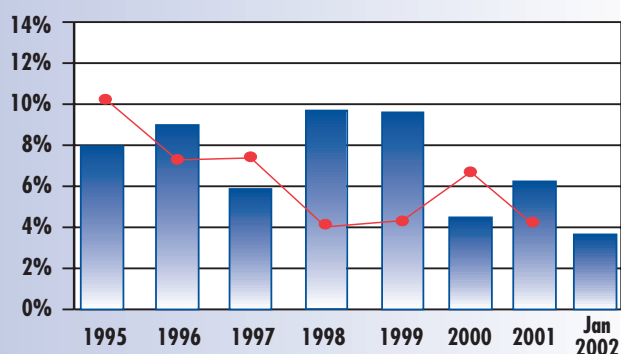
At the end of 2001, there were 176 registered labor federations and more than 9,700 private sector unions, a small increase over the previous year. The 3.6 million union members represent about 11 percent of the total workforce. The number of workers covered by collective bargaining agreements, however, fell during 2001 to 465,000, or about 13 percent of union members. There are also some 875 public sector unions, with a total membership of nearly 200,000.

In October 2001, the National Capital Region wage board approved a P30 Emergency Cost of Living Allowance (ECOLA) for Metro Manila workers. Labor groups complained that the ECOLA did not qualify as a real wage increase. At the National Socioeconomic Summit in December 2001, President Macapagal-Arroyo said job generation and preservation were central to her administration's action agenda. She endorsed a new "Job Corps" program to encourage self-employment projects and engage returning OFWs in community-based entrepreneurial activities.

Financial Markets

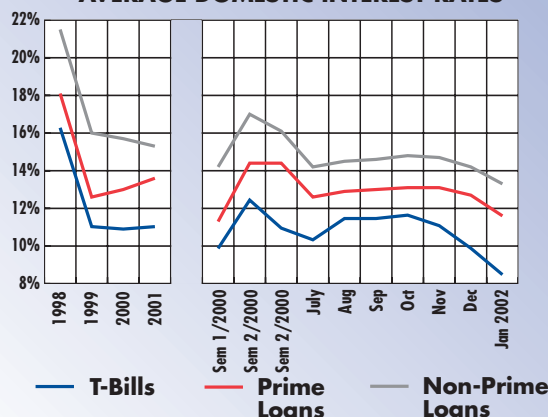
After a four-month hiatus, the Philippine Monetary Board — the highest policy-making body of the Bangko Sentral ng Pilipinas (BSP, the central bank) — reverted to a monetary-easing mode beginning October 2001 as downward pressure on the peso receded and inflation continued to slow. The monetary authority cut overnight borrowing and lending rates by a total of 125 basis points during the fourth quarter of 2001 — i.e., by 25 basis points effective October 5, by 50 basis points effective November 9, and by 25 basis points each effective December 7 and December 14. As of mid-February 2002, the BSP had followed through with two more cuts (25 basis points effective January 18 and another 25 basis points effective February 15). The Monetary Board has slashed overnight policy rates by 775 basis points in all since December 2000. BSP borrowing and lending rates currently stand at 7.25% and 9.5%, respectively —

CPI YEAR-TO-YEAR CHANGE



* Base Year 1994

AVERAGE DOMESTIC INTEREST RATES



the lowest they have been since July 1995. The Monetary Board also reduced “liquidity reserve” requirements (which, unlike statutory reserves, earn market-based yields) by a cumulative four percentage points between December 2001 and January 2002 — reversing the four percentage hike it had implemented between July and August.

Treasury bill rates moved up during the government’s weekly primary-market auctions in October 2001 despite preliminary monetary-easing signals by the Monetary Board. The increase apparently reflected initial uncertainties over U.S.-led military strikes on Taliban forces and lingering doubts over the government’s ability to control its fiscal deficit. However, except for a slight up-tick during the last primary-market auction of 2001, T-bill rates began to ease steadily starting November. By 2001’s second-to-the-last auction, loan-benchmark 91-day bills had tapered to an average rate of 8.787%, a five-month low. T-bill rates continued to slide in the first few auctions of 2002, responding to favorable inflation news and expectations of further BSP rate cuts. With bank lending still in the doldrums, the declines also reflected a dearth of relatively risk-free investment alternatives. By the February 11, 2002 auction, the 91-day T-bill had softened to an average rate of 7.278% (the lowest in fifteen years), with further short-term declines expected following the BSP’s most recent rate cut.

Commercial bank lending rates tapered with T-bill rates. From 13.1% in September 2001, average prime loan rates had come down to 12.7% by December and had softened further to an average rate of 11.6% by January 2002 (the lowest monthly average recorded since October 2000). Non-prime lending rates tapered from 14.8% (October 2001) to 14.2% (December 2001) and further to 13.3% (January 2002).

It is worth noting that, despite declines in nominal rates, real domestic interest rates were higher during the October 2001-January 2002 period than they were during most of the previous months of 2001. That rates did not come down more aggressively relative to inflation suggests banks’ continued risk aversion and the squeeze on profits imposed by non-performing assets and accompanying provisions for loan losses. Looking forward, rates may become stickier coming down after the first quarter,


taking the cue mainly from inflation trends and from unfolding developments on the fiscal front. The Bangko Sentral ng Pilipinas has indicated that monetary policy would proceed more cautiously to keep inflation in check. With inflation expected to accelerate during the second semester of the year as the economy’s expansion gains a firmer foothold, domestic interest rates are likely to follow suit.

Saddled with non-performing loans (NPLs) and a growing portfolio of foreclosed assets, banks remained cautious lenders, while weaker economic prospects translated to conservative credit demand. As of end-2001, outstanding loans of the commercial banking system (inclusive of inter-bank credits) were down 0.2% (P3.2 billion) from the end of 2000. On the other hand, non-performing loans (NPLs) increased by 14.7% (P36.1 billion) year-on-year. As a result, the ratio of non-performing loans to the commercial banking system’s total loan portfolio (i.e., NPL ratio) continued inching up — hitting a new high of 18.8% in November before declining to 17.4% in December. That lower, yearend NPL ratio resulted from a month-on-month decline in the nominal level of NPLs (reflecting late-year loan write-offs and debt restructuring) and some expansion in banks’ loan portfolios.

Restructured loans (without which NPL ratios would be higher) increased by 13.9% (P13.8 billion) between the end of 2000 and 2001 — rising from 6.1% to nearly 7% of the commercial banking system’s outstanding credits, respectively. Foreclosed assets, up 20.2% (P26.7 billion) from the end-2000 level, also rose rapidly. Non-performing assets (NPAs, the sum of NPLs and foreclosed properties) ended 2001 at P440.5 billion, up 16.6% from the end of 2000. End-2001 NPAs were estimated at about 14% of total commercial-banking system assets, up from 2000’s comparable ratio (12.1%).

Despite some respite in December, bankers doubt that non-performing loans have peaked, noting that businesses continue to struggle with both weaker export and domestic markets. Overall, the Philippine banking system’s generally healthy capital-adequacy ratios as well as adjustments in loan-loss reserves have helped the banking system avoid systemic problems. Computed according to the newly-adopted Basle Capital Accord formula, Philippine commercial banks’ average capital-adequacy ratio stood at 13.5% as of end-September 2001, higher than the BSP’s 10% statutory floor and the 8% internationally-accepted standard. Loan-loss reserves increased from 43.5% of banking system loans as of end-2000 to 45.1% as of end-2001. Still, it should be noted that significant troubles at any major commercial bank could lead to a swift reversal of depositor sentiment, and the resulting strain on the system to service withdrawals could be substantial.

Looking forward, a continued deterioration in asset quality could increasingly constrict banks’ margins, liquidity, and overall profitability. Some large banks are saddled by NPL ratios exceeding the industry average. A number of banks are actively exploring setting up or using the services of asset management



companies (AMCs) to clean up their non-performing accounts, some with U.S. firms such as Lehman Brothers and Cerberus. As part of its priority legislative agenda, the government is pushing for the passage of legislation which seek to promote asset securitization and the creation of AMCs to help banks clean up their portfolio of non-performing assets.

The BSP continues to encourage consolidation in the banking system through time-bound incentives and a temporary moratorium (since September 1999) on the issuance of new bank licenses. From September 2001 to mid-February 2002, the BSP approved 16 mergers involving 4 commercial banks, 8 thrift banks, 17 rural banks, and 1 non-bank financial intermediaries. This brings to 18 cases the acquisitions and/or mergers approved since the beginning of 2001. The BSP has approved 41 acquisitions and/or mergers thus far since the Asian crisis (involving 26 commercial, 22 thrift, 19 rural banks, and 6 non-bank financial intermediaries). Seven commercial, 37 thrift, and 181 rural banks remain short of minimum capitalization levels, suggesting there is room for further consolidation. About 10 acquisition and/or merger proposals are pending with the BSP.

In terms of number, smaller-capitalized thrift and rural banks (which constitute less than 10% of overall banking system assets) have been more severely affected by the shakeout. Nineteen more rural banks and 1 thrift bank closed between January 2001 and mid-February 2002 — for a total of 122 bank closures since mid-1997 (involving 2 commercial, 14 thrift, and 106 rural banks). The circumstances surrounding recent bank closures highlight remaining legal impediments to more effective bank supervision and timely intervention — including obstacles for bank regulators to examine banks at will, and the BSP's inability to reverse consummated transfers of bank ownership to questionable parties.

On the anti-money laundering front, the Financial Action Task Force (FATF) recommended that its members impose counter-measures on “non-cooperative countries” (which included the Philippines) unless they enact significant anti-money laundering legislation. The Philippine government passed legislation on September 29, 2001, beating the FATF deadline by a few hours. As a result, FATF decided not to impose sanctions, but has identified three key concerns about the law:

- The number of offenses covered is too narrow;
- The threshold for “covered transactions” is too high (\$80,000); and,
- The ability of the new Anti-Money Laundering Council to obtain court orders is limited.

The Philippines was given the opportunity to address these concerns on the margins of FATF's February plenary session in Hong Kong on January 28. While some officials continue to believe these concerns may be addressed by a fuller explanation

of the law and regulations, others now acknowledge that some legislative amendments may have to be made. Some in the Congress, however are opposed to changing the law, no doubt in some cases out of concern that lowering the financial “threshold” would expose their own accounts to scrutiny. Another problem is that the law provides for an intrusive congressional oversight committee, with substantial authority to interfere with implementation of the law, if it wishes.

The U.S. government is beginning to fulfill its pledge to provide technical assistance to the Philippines in implementing the Anti-Money Laundering Act, with a group of up to 11 Philippine officials scheduled to travel to the U.S. to visit FinCEN operations the first week of April. A FinCEN assessment team would visit the Philippines soon thereafter.

In the equities market, stock prices continued to falter on thin volumes from mid-September to mid-November. By early October, the Philippine Stock Price Index (Phisix) was struggling to keep above the 1,000 mark. From the fourth week of October to mid-November, the Phisix closed almost daily below the 1,000 level. The Phisix then began inching up on more aggressive interest-rate reductions, reported victories by U.S.-led anti-Taliban forces, positive inflation numbers, and the peso's relative stability. The Phisix nevertheless closed 2001 at 1,168.08, down 5.5% from mid-September 2001 and down 21.8% from end-2000. According to data compiled by the World Association of Exchanges on over 50 markets, the Philippine Stock Exchange (PSE) was the Asia Pacific region's worst performer in 2001 and, after Malta, second worst among more than 50 countries surveyed world-wide. Twenty-nine PSE member-broker firms ceased or suspended operations last year (including 17 foreign brokerages).

The stock market began 2002 on a more encouraging note. The Phisix recorded further gains on improved volumes during the first 1-1/2 months of the new year, buoyed by further yield declines on fixed-term investments, an improved U.S. and global economic outlook, and a number of other positive news (including a controlled fiscal gap and a recent ratings-outlook upgrade by Moody's Investors Service from “negative” to “stable”). Foreign investors have generally been net buyers of Philippine equities since the beginning of the new year — positioning themselves for potential upsides in under-weighted and under-performing Philippine stocks. Despite policy debates and criticisms, traders commented that the arrival of U.S. troops to assist in training Philippine military personnel engaged in the government's drive against the Abu Sayyaf group also helped boost investor sentiment. The Phisix closed January 2002 at 1,361.94 — up 16.6% from the end of 2001 — and inched up further during the first half of February. The Phisix closed at 1,416.83 on February 15, the highest in 7-1/2 months.

Fiscal Performance

Effective August 2001, the national government lowered its full year 2001 revenue target by P10 billion, partly to reflect lower economic growth expectations and significant shortfalls in internal revenue collections. Government fiscal managers slashed the Bureau of Internal Revenue's (BIR) 2001 collection goal by P20 billion while raising the target of the Bureau of Treasury and those for privatization receipts and government fees and charges by a total of P10 billion. The national government also cut its full year 2001 spending plan by a corresponding amount to maintain the programmed 2001 deficit ceiling at P145 billion.

Official statistics showed the national government's actual 2001 fiscal deficit at P147 billion — somewhat over the programmed level in nominal terms (although within the 4% deficit-to-GDP ratio envisioned for that year). Revenues exceeded the revised target by P5.5 billion mainly because of the Treasury's much higher-than expected income — which offset an P8.9 billion shortfall in customs collections (attributed to the slump in imports) and in privatization receipts (which generated only P1.2 billion of the P10 billion target). The Treasury's better-than-expected performance reflected higher-than-forecasted investment incomes, more determined efforts to collect on dividends from government-controlled firms, and other extraordinary inflows (including a P4 billion fee for government-guaranteed bond flotation for state-controlled National Power Corporation).

The BIR slightly exceeded its reduced 2001 collection goal. Higher-than-expected revenues kept the fiscal deficit more or less in check even though the national government overshot its downward-revised spending target. Encouraged by stronger-than-expected, non-tax revenue flows and lower-than-programmed interest payments (reflecting lower-than-projected domestic interest rates and some shift in the financing program from domestic loans to relatively cheaper foreign-denominated borrowings), the government opted to relax its tight hold on fund releases during the last few months of the year.

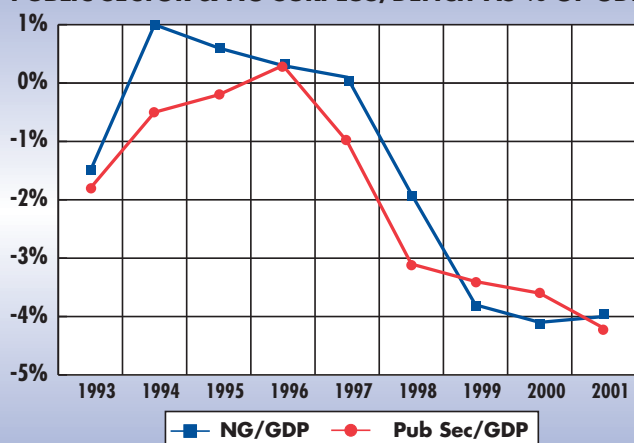
The consolidated public sector (which includes government-controlled firms, social security agencies, local government units, and the Bangko Sentral ng Pilipinas) recorded a P126.7 billion deficit during the first nine months of 2001 (equivalent to 4.9% of GDP). That deficit was below the P130.7 billion (5.1% of GDP) program for January-September 2001, reflecting lower-than-expected deficits of public sector firms (partly because of cost-reduction moves, including deferred capital investments) and better-than-expected surpluses registered by the Philippine central bank, social security agencies, government financial institutions, and local government units.

Based on partial data, government fiscal planners project the consolidated public sector deficit to have ended 2001 at roughly P155 billion (4.2% of GDP), within the government's P166.5 billion program for that year. Looking forward, the restructuring of the electric sector and privatization of the National Power Corporation (NAPOCOR, the government's debt-saddled power generating company) under the provisions of Electric Power Industry Reform Act continue, albeit with some delays. The implementing Rules and Regulations were published on March 7 and will enter into effect 15 days after that date. The privatization rules are expected to be adopted in the coming weeks. Meanwhile, the Department of Energy has suspended "road shows" aimed at soliciting foreign investment until this and other issues related to the privatization — including the legislative amendment to transfer the franchise for the transmission assets from NAPOCOR to another entity — are resolved. Another important challenge the government faces is addressing threats to the long-term viability of state-run pension funds arising from imbalances between contributions received and benefits paid.

President Gloria Macapagal-Arroyo signed the national government's P780.8 billion (US\$15.3 billion) obligation budget for 2002 into law on January 21 — the first budget crafted by the Macapagal-Arroyo administration after functioning under a re-enacted 2000 budget for the 2001 calendar year. Although 11.6% (P80.9 billion) higher than 2001, the 2002 budget nevertheless remains tight. Our estimate of "non-discretionary" expenditures — i.e., the sum of personnel costs, debt service payments, and legally-mandated transfers to local government units — shows that these items will eat up more than 75% of the 2002 budget pie and two-thirds of the planned year-on-year budget increase. After these outlays, the national government hopes to have enough resources to allow a double-digit (about 24%) expansion for its own maintenance/operating and capital-spending needs — just about making up, however, for the declines suffered by these expenditure items last year.

By broad sectoral classification, the government aims to beef up the 2002 allocations for economic services, defense, and general public services, also to make up for cuts suffered in 2001. Meanwhile, the 7.7% nominal increase programmed for social services will translate to only modest growth in real terms (based

PUBLIC SECTOR & NG SURPLUS/DEFICIT AS % OF GDP



on the government's 5% to 6% inflation-rate forecast for 2002); and to barely any improvement in real per capita terms (considering the Philippines' estimated 2.36% annual population growth rate).

The leeway ultimately available for "discretionary" but essential budget items (including outlays for maintenance and infrastructure) will depend, moreover, on the government's ability to meet revenue goals. Geared towards reining in the national government's 2002 fiscal deficit within a lower P130 (3.3% of GDP) ceiling, the 2002 revenue program calls for a 17% year-on-year expansion in tax collections. Roughly half of that expansion will depend on achieving macroeconomic targets, including a 4.0%-5.0% real GDP growth rate (currently considered optimistic by most non-government economists); and the balance on improving the tax-to-GDP ratio by a full percentage point (from 13.4% in 2001 to 14.4% in 2002). These goals form part of a medium-term fiscal program which envisions declining deficits starting in 2002, towards balancing the consolidated public sector and national government budgets by 2005 and 2006, respectively.

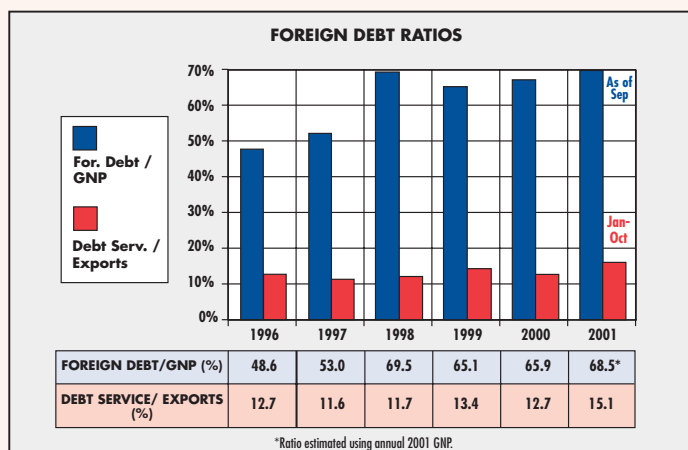
All told, the government continues to juggle extremely inadequate resources even as demands intensify for the current administration to deliver on its anti-poverty promises. The Philippines' tax-to-GDP ratio ranks among the poorest in the region, peaking at no more than 17.1% in 1997 before deteriorating in subsequent years. While part of that deterioration has been blamed on Asian crisis-related difficulties, estimates by independent fiscal experts confirm an undeniably pressing need for more aggressive tax-administration improvements. Tax evasion rates for individual-income and value-added taxes, for example, have been estimated to be as high as 60% (equivalent to well over P100 billion in annual tax-collection losses). On the expenditure side, the large share of "non-discretionary budget" items leaves the government with little leeway for fiscal maneuvering without trading off essential infrastructure investments and social development objectives.

The Macapagal-Arroyo government has assembled a well-respected economic team and deserves praise for its strong resolve to keep its fiscal deficit in check. Achieving long-term fiscal viability will require strong political will, especially where perceived corruption and inefficient tax collection have increased public resistance to new taxes and eroded the intended gains of past restructuring efforts. Beyond the immediate challenge of allocating scarce resources among competing needs, effective revenue mobilization remains crucial to sustaining a responsible deficit-reduction plan that supports the socio-economic needs of a growing population, addresses serious infrastructure deficiencies, and harnesses the human-resource capabilities demanded by intensifying global competition.

Foreign Debt and Debt Service

To support low domestic interest rates, the government's goal is to shift the financing burden to foreign borrowings in 2002 to the tune of about \$2.8 billion (equivalent to about 54% of total funding needs, from less than 25% in 2001). About \$1.3 billion (46%) of that amount will depend on the government's ability to improve utilization of concessional official development assistance (ODA) loans, an issue of long-standing concern to foreign donors. The government failed to utilize about 40% of \$8 billion in committed ODA financing which should have been drawn by the end of 2001. These funds are held up for various reasons (including legislative roadblocks, lack of counterpart funds, right-of-way problems, and bureaucratic delays). The current administration is working to rationalize its \$12 billion ODA loan portfolio in order to save on commitment fees and to better prioritize and manage the limited resources currently available for local counterpart financing.

The remaining \$1.5 billion of the national government's 2002 foreign borrowing program consists of commercial credits. As of end-January 2002, the national government had raised 60% of its commercial funding requirement for the current fiscal year — \$400 million from a November 2001 shibosai bond issue and \$500 million from a January 2002 global bond float. The national government expects to raise the remaining 40% through another global bond issue within the first quarter of 2002. Moves in recent months to front-load commercial borrowings for the 2002 budget year reflected tighter spreads over U.S. Treasuries (which narrowed to below 500 basis points, from a peak of nearly 800 basis points post-September 11); and the increased competition expected from much larger global funding requirements. In early February 2002, Moody's Investors Service upgraded the Philippines' sovereign-ratings outlook from "negative" to "stable" — citing, among others, improved macroeconomic prospects and fiscal-deficit control efforts. The government is hoping for a similar upgrade from Standard and Poor's to further improve the Philippines' access to international credit markets at cheaper rates.

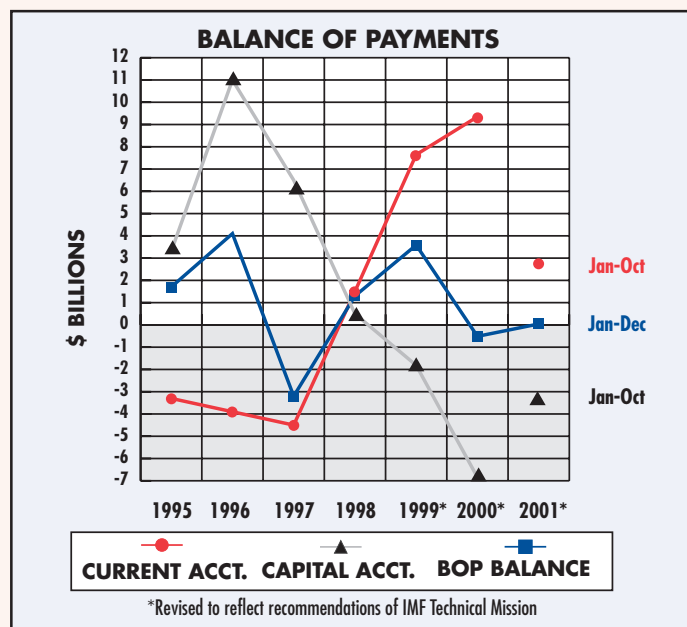


According to the most recent quarterly estimates, the Philippines' recorded external debt (based on foreign credits approved or registered with the Bangko Sentral ng Pilipinas) stood at \$52.5 billion as of end-September 2001. That level represented a 0.7% (\$366 million) expansion from end-2000's \$52.1 billion level and a 3% (\$1.53 billion) increase quarter-on-quarter. The increase from the June 2001 level mainly reflected upward revaluation adjustments (\$904 million, reflecting the appreciation of non-US\$ credits). Net borrowings by the BSP (US\$400 million) and by the private non-bank sector (US\$300 million) also contributed to the quarter-on-quarter expansion of the Philippines' foreign debt stock. Medium and long-term loans (with a weighted average maturity of more than 16 years) constituted 88.9% of outstanding external obligations. Almost half of external obligations were obtained from official creditors (defined as foreign governments and their export credit agencies, and multilateral financial institutions) at more concessional terms.

The foreign debt service burden — measured as the ratio of debt service payments to merchandise and service export receipts spiked to 15.1% during the first ten months of 2001. The comparable 2000 ratio was 12.4%. The heavier foreign debt service load reflected a \$231 million year-on-year expansion in debt service payments and a \$5.7 billion year-on-year slump in merchandise export and service receipts. If the ratio holds at about 15%-16% for the full year (as the BSP estimates), this will be the highest foreign debt service burden posted since the mid-1990s. These developments suggest vulnerabilities to unexpected reversals in export markets — highlighting the importance of addressing the weak state of government revenues and attracting more sustainable, non-debt sources of balance of payments financing.

Merchandise Trade and Balance of Payments

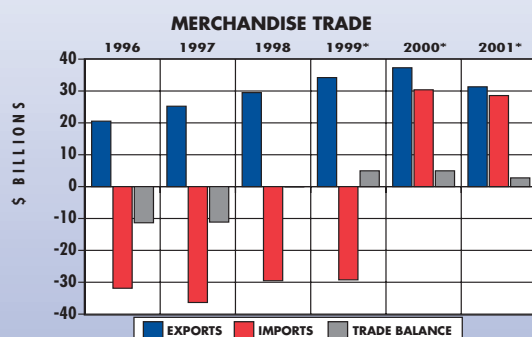
Although full year balance of payments (BOP) details were not yet available when this issue of the Philippine Economic Outlook went to print, preliminary estimates (computed from the change in BSP net international reserves) placed the 2001



BOP position at a \$42 million surplus. The BOP deficit had ballooned to \$1.5 billion during the first ten months of the year as net outflows in the capital and financial account more than wiped out a much narrower current account surplus. Boosted mainly by late-year foreign borrowings, the BOP balance eventually managed to end 2001 in the black — barely skirting what could have been a second consecutive year in the red. These late-year BOP inflows included proceeds from a eurobond float (\$444 million), a shibosai bond issue (\$400 million), US\$-denominated Treasury bills (\$119 million), BSP fixed-rate notes (\$550 million), and about \$200 million in loan draw-downs from multilateral donor agencies.

Available BOP details through October 2001 showed the Philippines' current account surplus at \$2.8 billion, barely 41% of 2000's comparable ten-month level. The more modest current account balance resulted from smaller net receipts from merchandise trade, investment incomes, and overseas workers' remittances. These combined with a somewhat larger service account deficit, where a 16.5% (\$551 million) decline in revenues — including an 18.8% (\$345 million) drop in tourism-related receipts — outpaced a 10.6% (\$525 million) contraction in service payments.

The capital and financial account posted a smaller ten-month deficit of \$3.4 billion vs. 2000's comparable \$4.4 billion gap. Net foreign direct investments slumped by 21.3% year-on-year to \$1.8 billion. On the other hand, net portfolio investments reversed from a \$68 million deficit to a \$297 million surplus. That reversal reflected divestments by Philippine residents of foreign-issued debt and equity securities — which made up for a 35.7% (\$173 million) year-on-year drop in net portfolio inflows from foreign investors. A lower net outflow in the "other investment" account (consisting of trade credits, loans, and currency and deposits) also contributed to a wider capital and financial account gap. That lower deficit mainly reflected smaller net repayments for short-term trade credits.



	1996	1997	1998	1999*	2000*	2001*
EXPORTS	20.543	25.228	29.496	34.210	37.295	31.318
IMPORTS	-31.885	-36.355	-29.524	-29.251	30.380	28.576
TRADE SURP/DEFICIT	-11.342	-11.127	-0.028	4.959	6.915	2.742

*Revised to reflect recommendations of IMF Technical Mission

FDI Flows Decline

BSP data reflect actual foreign direct investment (FDI) inflows (versus FDI approvals recorded by various government investment-promotion agencies such as the Board of Investment, Philippine Export Zone Authority, Clark Development Authority, and the Subic Bay Metropolitan Authority). BSP registration is required to allow firms access to foreign exchange from the banking system for capital repatriation and income remittance purposes. BSP-registered FDI's dipped by 38.6% year-on-year in 2001 to \$858 million (the lowest full year level registered since 1996).

BSP-Registered Foreign Direct Investments (Annual Flows, In Million US\$)

	1995	1996	1997	1998	1999	2000	2001
Total	815	1,281	1,053	885	2,107	1,398	858
U.S.	56	293	117	243	84	245	193
Japan	244	471	331	150	303	100	193

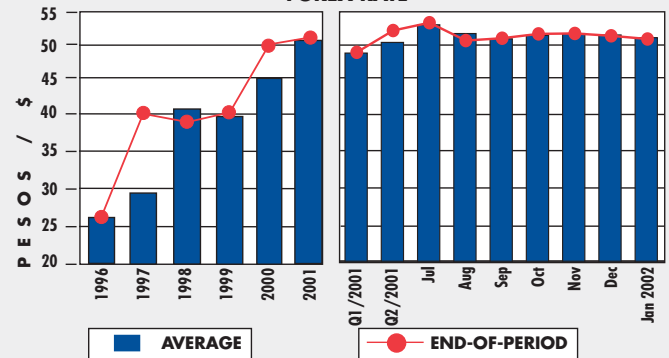
The global economic and electronics demand slowdown combined with softer prices of resource-based commodities to depress export performance. Down by a cumulative 9.8% year-on-year during the January-June period, the export slump deepened during the second half, with export receipts dipping by 21.4% from 2000's second-semester level. On a full year basis, 2001 export receipts contracted by 16%, dragged down by a nearly 24% drop in revenues from shipments of electronic and telecommunications parts and equipment (which comprise about 60% of annual export revenues). Full year commodity exports last declined year-on-year in 1985. The import bill — although down nearly 6% — did not slow as much as exports because of low inventory levels. As a result, the Philippines' trade-in-goods surplus narrowed to \$2.7 billion during 2001, less than two-fifths of 2000's comparable balance.

Despite the late-year 2001 reversal to a modest BOP surplus, we believe that threats remain to achieving a balanced BOP position in 2002. We currently expect flat to modest (i.e., less than 5%) year-on-year export growth which, combined with some expansion in imports, may not result in an improved merchandise trade balance. This places the burden of achieving a balanced external-account position on improved capital and financial flows.

Foreign Exchange Rate and International Reserves

The peso traded within a relatively narrow band of P51.00-P51.41/US\$ during the second half of September 2001, little changed from the P50.94-P51.35 range at which it had traded during the first half of that month. Traders attributed the relatively stable peso during that time to the generally weaker sentiment for the US\$ immediately following the September 11

FOREX RATE

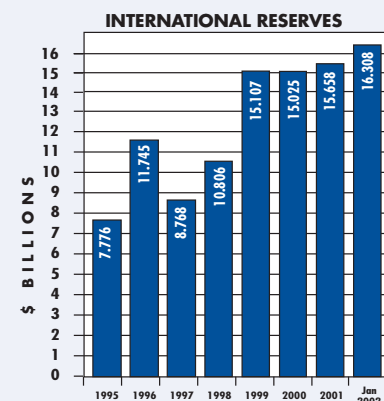


*End-of-period data refers to average foreign exchange rate on last trading day of indicated period.

terrorist attacks on the United States. The peso, however, began to slip in succeeding weeks as suspense over subsequent U.S.-led, counter-terrorist military strikes escalated, combining with a dearth of foreign exchange flows (headlined by a deepening export slump) and, as global economic and political uncertainties increased, with weaker regional currencies. By the last week of October, intra-day transactions were breaching the P52.00/US\$ mark and the peso traded within a weaker P51.72-P52.18/US\$ band until mid-December.

The peso has since strengthened, buoyed in part by heftier December 2001 and January 2002 gross international reserve levels and a number of encouraging domestic news (including positive reports on the inflation and fiscal fronts and Moody's ratings-outlook upgrade). The peso closed 2001 at P51.665/US\$. At that rate, the peso was 3.3% weaker than at the end of 2000 (P50.01/US\$) and had depreciated by 0.7% from the P51.30 (September 14, 2001) closing level which we last reported in the October 2001 edition of the *Philippine Economic Outlook*. The local currency gained further during the first one-and-a-half months of 2002, closing at P51.220/US\$ on February 15 (up 0.9% from the end of 2001).

The BSP's gross international reserve (GIR) cushion had declined from more than \$15 billion at the beginning of 2001 to \$14.4 billion as of end-October, reflecting weak balance of payments flows. However, the GIR level improved in subsequent months, ending 2001 at a significantly heftier \$15.7 billion (equivalent to 4.8 months' worth of trade and service payments) — pushed up by over \$1.2 billion worth of late-year foreign-borrowing proceeds. By end-January 2002, the BSP's GIR level had risen to an all-time high of \$16.3 billion (equivalent to five months' worth of trade and services imports), boosted by another



\$1.1 billion of national government and BSP foreign credits. That cushion equaled 134% of public and private sector debt maturing over the next twelve months. Considered as “secondary reserves,” the BSP estimated that banks’ foreign currency deposit units (FCDUs) had about \$12 billion in deposits as of end-2001, more than 90% of which represented deposits of Philippine residents.

Despite the peso’s recent strength, we still expect the local currency to weaken this year relative to its 2001 average rate of P50.99/US\$. The GIR improvement in recent months came mainly from non-recurring sources (i.e., foreign borrowings), making it potentially difficult to maintain international reserves at current levels unless trade receipts and capital flows strengthen from currently lethargic levels. Domestically, budget-deficit control, if sustained, and more moderate inflation will be plus factors for a relatively stable peso. Provided there are no severe external and/or domestic shocks, our current reading is for a modest peso depreciation to an average 2002 rate of P51.60-P52.25/US\$.

Challenges and Prospects

The Arroyo Administration has received good reviews from the business sector and the international capital markets for pursuing macroeconomic stability, especially fiscal discipline. Its greater success will depend on its ability to pursue structural reforms to eliminate bottlenecks to growth and efforts to promote good governance. Beyond legislation to strengthen the banking sector and to modernize the investment framework by harmonizing existing fiscal incentive regimes, successfully restructuring the power sector and proceeding with privatization of NAPOCOR will be a critical test of its commitment to reform. The many challenges are made all the more difficult by the government’s need to focus resources and time to securing peace and development in Mindanao.

In her July 2001 State of the Nation Address (SONA) and subsequently at the United Nations and other fora, President Macapagal-Arroyo has linked her administration’s war against poverty to the war against terrorism, especially targeting areas most affected by armed conflict. Poverty incidence in the southern Philippines is especially severe (estimated at more than 70% in the Autonomous Region of Muslim Mindanao (ARMM, which includes the provinces of Basilan and Sulu — major areas of Abu Sayyaf operations). This commitment to bring peace and development to Mindanao and to adopt a free enterprise approach to poverty alleviation were again reflected in the government’s meeting with its development partners in March this year. The government also committed to provide greater resources to address domestic peace-and-order and security concerns, a top issue raised by domestic and foreign business chambers.

Looking forward, the Philippines faces many difficult challenges. Perhaps the most pressing — and persistent — is the need to

PROJECTIONS FOR 2002: SELECTED INDICATORS

	2000 Actual	2001 Actual	2002 Forecast ^a
GDP Growth (Year-on-Year, %)	4.0	3.4	3.5-4.0
GNP Growth (Year-on-Year, %)	4.5	3.7	3.9-4.3
Average Year-on-Year Inflation (1994=100, in %)	4.4	6.1	4.8-5.2
Average 91-day T-bill Rate (%)	9.94	9.75	8.5-9.2
Average Forex Rate (Pesos/US\$)	44.19	50.99	51.60-52.25
Exports (\$Billions)	37.3	31.3	31.3-32.2
Growth (Year-on-Year, %)	9.0	(16.1)	0.0-3.0
Imports (\$Billions)	30.4	28.6	29.5-30.0
Growth (Year-on-Year, %)	3.9	(5.9)	3.0-5.0
Trade Balance (\$Billions)	6.9	2.7	1.8-2.2

^aEmbassy projections as of March 2002

Sources: National Economic and Development Authority, Bureau of Treasury, Bangko Sentral ng Pilipinas

increase government revenues for the long run. NPLs and a growing portfolio of foreclosed assets continue to haunt the banking sector. BOP vulnerabilities also remain. The Philippines historically has posted trade and current account surpluses during periods of economic weakness, with risks of reverting to deficits as economic expansion accelerates. While trade liberalization presents vast opportunities, intensifying global competition and the emergence of large, low-wage export economies also pose challenges. Longer-term BOP stability hinges heavily on the Philippines’ ability to harness non-debt sources of foreign exchange in a more and more open and competitive world economic environment. Although manageable, the foreign debt-service burden increased quite markedly in 2001 (mainly because of declining exports), highlighting potential debt-servicing risks posed by reversals in export markets and dependence on foreign debt and, therefore, the importance of enhancing non-debt sources of BOP and budget financing.

On the plus side, the Philippines has shown a unique and very stable consumption spending pattern, unlike its Asian neighbors whose spending pattern reflects much volatility. Overseas Filipino workers’ remittances continue to contribute to consumer spending, despite concerns caused by conflict in the Middle East. Additional jobs were created in the agriculture and services sectors, offsetting losses in the industrial sector. Together with a recovery of the U.S. economy and a strengthening in the European economies, a more benign global environment is expected to provide more room for improvements and stability in the second half of the year.

Agriculture, supported by the rehabilitation of irrigation facilities to temper the effects of a mild El Niño, and service sector growth, featured by robust performances by the trade and telecommunications sectors, are expected to generate the bulk of the growth for 2002. Passage of legislation to strengthen the banking sector and to facilitate the creation of AMCs will play a critical role.

PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	1999	2000	2001 <i>p/</i>
Domestic Economy			
Population (millions, 2000 census)	74.7	76.5	78.3
Population growth (%)	2.36	2.36	2.36
GDP (current) <i>a/</i>	76,155	74,736	71,438
GNP (current) <i>a/</i>	80,299	79,003	75,702
Per Capita GDP, current dollars <i>a/</i>	1,019	977	912
Real GDP (% change, yr.-on-yr.)	3.4	4.0	3.4
Real GNP (% change, yr.-on-yr.)	3.7	4.5	3.7
Consumer Price Index (ave. % change, yr.-on-yr. 1994=100)	6.7	4.4	6.1
Production, Employment, Fiscal Accounts			
Unemployment rate (%) <i>b/</i>	9.8	11.2	11.2
Industrial prod. (1985=100), % change yr.-on-yr.	0.9	3.9	1.9
Nat'l gov't budget surplus/(deficit) <i>a/</i>	(2,856)	(3,080)	(2,883)
as % of GDP	(3.8)	(4.1)	(4.0)
Consolidated public sector surplus/(deficit) <i>a/</i>	(2,570)	(3,481)	(3,033)
as % of GDP	(3.4)	(4.6)	(4.2)
Interest Rates (%)			
Weighted average T-bill rate (all maturities)	10.67	11.15	11.03
Average prime loan rate	12.6	12.9	13.6
Balance of Payments			
Exports (FOB)	34,210	37,295	31,318
Growth (% , yr.-on-yr.)	18.8	9.0	(16.0)
Imports (FOB)	29,252	30,380	28,576
Growth (% , yr.-on-yr.)	4.1	3.9	(5.9)
Trade balance	4,958	6,915	2,742
Current account surplus (deficit)	7,647	9,349	2,757
as % of GNP	9.5	11.8	4.5
BOP surplus/(deficit)	3,588	(513)	42
Foreign Debt, as of end of period <i>c/</i>			
Debt service paid	52,210	52,060	52,426
Debt service (% of exports of goods and services)	6,319	6,226	5,221
	13.4	12.7	15.1
BSP International Reserves, as of end of period			
	15,107	15,025	15,658
Exchange Rate (pesos/\$)			
Average exchange rate	39.09	44.19	50.99
Closing ave. exchange rate <i>d/</i>	40.30	49.99	51.69
Foreign Direct Investment (BSP registrations) <i>e/</i>			
Total (cumulative, since 1973)	11,412	12,810	13,668
U.S. (cumulative, since 1973)	2,806	3,052	3,245
U.S. share (%)	24.6	23.8	23.7
U.S.-Philippine Trade (Phil. Data) <i>f/</i>			
Philippine exports to U.S., FOB	10,445	11,381	8,975
Growth (% , yr.-on-yr.)	3.4	9.0	(21.1)
Philippine imports from U.S., FOB	6,365	4,879	4,991
Growth (% , yr.-on-yr.)	(3.0)	(23.3)	2.3
Philippine trade balance with U.S.	4,080	6,501	3,984
U.S. share of Philippine imports (%)	21.8	16.1	17.5

a/ originally peso values, converted to USD; *b/* annual figures computed as average of quarterly surveys (Jan/Apr/Jul/Oct); *c/* excludes "net due to" accounts of foreign commercial banks and private sector loans not approved and/or registered by/with the BSP; *d/* average on last trading day of indicated period; *e/* principally exercised to enable foreign exchange purchases from the banking system for capital repatriation and profit remittances; *f/* differs from USG data (for 2001, USG statistics estimated U.S. exports to the Philippines at \$7,665 million, U.S. imports from the Philippines at \$11,331 million, and the Philippines' trade surplus with the U.S. at \$3,666 million); *p/* preliminary.

Sources: National Economic and Development Authority; Department of Finance; Bureau of the Treasury; Bangko Sentral ng Pilipinas